

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFPH:ATL:POSTF-109498-02 WLI-2
KAPalmerino

date: August 27, 2002

to: Danny Horner, International Examiner
Rita Cox, Team Coordinator

from: Associate Area Counsel (LMSB)

subject: Source of Loss on Sale of Stock of Foreign Subsidiary

This is in reply to your request dated June 12, 2002 in which you requested we provide our views on the source of the loss incurred by [REDACTED] ("[REDACTED]") on the sale of stock in its controlled foreign corporation, [REDACTED] ("[REDACTED]"). This memorandum should not be cited as precedent.

Conclusion:

(b)(5)(AWP), (b)(5)(AC)

[REDACTED]

Facts:

On [REDACTED], [REDACTED] sold the stock of [REDACTED] to an unrelated third party claiming a loss on the sale of approximately \$[REDACTED].¹ Shortly before the sale date, [REDACTED]

¹ We are looking at several issues affecting the proper amount of the loss.

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received a \$ [REDACTED] dividend from [REDACTED]. On its Form 1120 for the [REDACTED] taxable year [REDACTED] allocated the loss entirely to reduce U.S. source income.

Law and Analysis:

Section 865(a) of the Code, effective for taxable years beginning after December 31, 1986, provides generally that income from the sale of personal property by a United States resident will be sourced in the United States. Exceptions to that rule for inventory and for depreciable personal property are contained in sections 865(b) and (c), which have no application to the facts of this case.

Section 865(j) provides the Secretary with the authority to prescribe such regulations as may be necessary or appropriate to carry out the purpose of section 865, including regulations relating to the treatment of losses from the sale of personal property.

Proposed regulations addressing the allocation of losses under section 865 were issued on July 8, 1996. The proposed regulations generally adopted a residence-based source rule, but provided for certain exceptions. Specifically, with respect to the sale of stock Proposed Treas. Reg. § 1.865-2(b)(1) contained a dividend recapture exception². See Proposed Income Tax Regs., 61 Fed. Reg. 35696-35700 (July 8, 1996).

The proposed regulations, specifically those applicable to the source of losses with respect to stock, were finalized in January, 1999, together with a temporary anti-abuse rule (the matching rule) that provided that to the extent a taxpayer recognizes foreign source income for tax purposes that results in the creation of a corresponding loss with respect to stock, the loss shall be allocated and apportioned against such income. See Temp. Treas. Reg. § 1.865-2T(b)(4)(iii), T.D. 8805, 64 Fed. Reg. 1505 (January 11, 1999). The preamble to the temporary regulations explained that this rule was intended to prevent taxpayers from avoiding the dividend recapture rule or from accelerating foreign source income and recognizing an offsetting

² Preliminary information indicates that approximately \$ [REDACTED] of the loss on the sale of the stock of [REDACTED] would be allocable to foreign source income under the dividend recapture exception.

U.S. loss.³ Treas. Reg. §1.865-2(e) and Temp. Treas. Reg. §1.865-2T(e) provided that the final and temporary regulations are applicable to losses recognized on or after January 11, 1999, unless the taxpayer chooses to apply the rules to an earlier taxable year and complies with the requirements for doing so.

The facts in this case are similar to the facts in International Multifoods, with the significant exception that in the Multifoods case no substantial dividend was paid shortly before the stock sale. At the time the court issued its opinion, the proposed stock loss regulations had been published but the 1999 temporary and final regulations had not been issued. The court held that Treas. Reg. §1.861-8(e)(7) was no longer applicable for post-1986 years due to the enactment of I.R.C. §865. Citing the legislative history of section 865 and the General Explanation of the Tax Reform Act of 1986⁴, the Tax Court stated that in the absence of any authority negating the general rule of residence-based sourcing, loss from the sale of stock in a foreign corporation by a U.S. resident was allocable to reduce U.S. source income.

Since no AOD has been issued with respect to this case, the official legal position of the Service remains that Treas. Reg. §1.861-8(e)(7) controls the source of losses for transactions not covered by the final section 865 stock loss regulations.⁵

(b)(5)(AWP), (b)(5)(AC)

(b)(5)(AWP), (b)(5)(AC)

³ The matching rule was modified when finalized in 2001 to provide that the rule will only apply if a taxpayer engages in a transaction or series of transactions with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss. See T.D. 8973, 66 Fed. Reg. 67081 (December 28, 2001). The final regulation matching rule is applicable to losses recognized on or after January 8, 2002, unless the taxpayer chooses to apply the rule to an earlier taxable year and complies with the requirements for doing so. Treas. Reg. §1.865-2(e).

⁴ Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (J. Comm. Print 1987).

⁵ Application of Treas. Reg. §1.861-8(e)(7) in this case would result in the loss on the sale of the [REDACTED] stock being allocated to reduce foreign source income. See Black & Decker v. Comr., 986 F2d 60 (4th Cir. 1993).

(b)(5)(AWP), (b)(5)(AC)

Although the dividend recapture rule of Treas. Reg. §1.865-2(b)(1) and the matching rule of Treas. Reg. §1.865-2(b)(4)(iii) were not applicable at the time of the [REDACTED] stock sale, it does not necessarily follow that the loss on the sale of that stock should be allocated entirely to reduce U.S. source income under the general residence-based source rule adopted by the court. The court in a footnote to the International Multifoods opinion stated that it recognized that exceptions to the general rule of residence-based sourcing may be appropriate in certain situations to prevent abuse. Id. at 590, n.7.

We believe that [REDACTED]'s payment of a \$[REDACTED] dividend to [REDACTED] shortly before the sale date is the type of situation contemplated by the court in International Multifoods. Had the [REDACTED] sale occurred on or after January 11, 1999, or had the taxpayer elected to apply the regulations retroactively, the loss would have been subject to the dividend recapture exception of Treas. Reg. §1.865-2(b)(1) or the anti-abuse matching rule of Treas. Reg. §1.865-2(b)(4)(iii). (b)(5)(AWP), (b)(5)(AC)

[REDACTED]

Please do not hesitate to contact the undersigned if we can be of further assistance in this matter.

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(LMSB)

By: 
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